Improving Tax Fairness:

A Corporate Minimum Tax for Ontario

Supplementary Paper
1993 Ontario Budget

Improving Tax Fairness: A Corporate Minimum Tax for Ontario

PRESENTED TO THE
MEMBERS OF THE LEGISLATIVE
ASSEMBLY OF ONTARIO BY
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Improving Tax Fairness: A Corporate Minimum Tax for Ontario

Preface

Ontarians know the tax system plays a key role in society. For example, it redistributes resources and raises money to pay for important public services. These services include health care, social assistance, education, training and maintaining the provincial infrastructure. Maintaining the quality of public services is vital to Ontario's long-term economic renewal.

For a tax system to work, it has to earn the public's trust. People must feel they are getting value for their money. They must feel they have a say in how the tax system is shaped. And people must feel the tax system is fair. Greater tax fairness improves legitimacy and builds confidence in the system.

This Government has shown a clear commitment to increasing public involvement in decision-making. The Government established the Fair Tax Commission (FTC) in 1991 to consult widely and recommend ways of improving the fairness of the tax system. In addition, the budget consultation process has been expanded to include broader representation. These steps have opened up the tax policy process to more and more groups in society.

Improving the fairness of the tax system is a fundamental component of the Government's tax reform agenda. One way of improving the fairness of the corporate tax system is through a Corporate Minimum Tax (CMT). A CMT would ensure that profitable corporations pay at least a minimum amount of corporate income tax.

In the 1992 Ontario Budget, I said, I would release a technical paper identifying an appropriate CMT for Ontario. This paper fulfils this commitment and builds on the work of the FTC working group on a CMT for Ontario. This technical paper considers three approaches to a CMT and outlines the rationale for basing the CMT on a corporation's adjusted book income.

The CMT will affect only large, profitable corporations paying little or no corporate income tax. It will apply to corporations with total assets greater than $5 million or gross revenues greater than $10 million. Small businesses will be exempt. As a result, over 90 per cent of all corporations in Ontario will not have to calculate or pay the CMT.

The Government is committed to making sure Ontario's corporate tax system supports economic renewal. The 1992 Budget measures to lower corporate income tax rates for small business and manufacturing and resource industries and to stimulate research and development and new investment will continue. In addition, the 1993 Ontario Budget includes measures to foster technological innovation. These measures will improve Ontario's tax competitiveness and prospects for economic renewal.

The CMT will not eliminate new or existing tax preferences. Instead, it will ensure that large, profitable corporations do not use tax preferences to completely eliminate or unduly minimize their corporate income taxes. Ontario will continue to be competitive with the United States. It is important to note that the United States, for example, imposes a more complex and onerous minimum tax on corporations.

In the coming weeks, the Government will be undertaking technical consultations on the corporate minimum tax. Those interested in commenting on the technical paper may send their written submissions to me by September 30, 1993.

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Introduction

The corporate tax system should ensure that profitable corporations pay a fair and reasonable amount of corporate income tax based on their ability to pay. This principle of fairness has been undermined by the fact that some profitable corporations pay little or no corporate income tax. To address this situation, the Government will be implementing a Corporate Minimum Tax (CMT). This paper, which describes Ontario's CMT, is the result of an extensive review of this issue.

In March 1991, the Government established the Fair Tax Commission (FTC) to provide advice on how to improve the fairness of the tax system. In the 1991 Ontario Budget, the Minister of Finance subsequently requested the FTC to accelerate its review of a corporate minimum tax. A working group of 18 members was appointed in June 1991 to determine what type of CMT would be most effective in improving the fairness of the tax system by ensuring that all profitable corporations pay their fair share of corporate income tax. Members were selected from a broad cross-section of the public and included representatives from business, labour and other community groups. Over the next nine months, the group undertook a review of minimum taxation, which culminated in a report released in March 1992.

The Government has benefited greatly from the deliberations of the working group. The working group identified several key principles that should govern the design of a CMT. Based on the principles announced in the 1992 Ontario Budget, the CMT has been designed so that:

- the CMT base excludes intercorporate dividends and equity income to avoid double taxation;
- the CMT recognizes losses of other years to enhance its sensitivity to ability-to-pay;
- the CMT includes provisions that minimize retroactivity;
- CMT paid is creditable against regular income tax liabilities of future years; and
- small businesses are exempt from the CMT.

In response to the recommendation of the working group that the Government undertake further analysis, the Minister of Finance announced, in the 1992 Ontario Budget, that he would release a technical paper on an appropriate CMT for Ontario.

This paper provides a detailed description of Ontario's CMT. As announced in the 1993 Ontario Budget, the Corporate Minimum Tax will be introduced effective January 1, 1994. When fully phased in, the CMT will be levied at a rate of 4 per cent on Ontario adjusted book income. This tax base will ensure that the CMT is sensitive to ability-to-pay. The CMT is estimated to raise about $100 million on a full-year basis. In keeping with its commitment to consult prior to the introduction of legislation, the Government is asking all interested parties to

present their views on the technical aspects of the CMT. The Government will be receiving written submissions until September 30, 1993.

The Need for a CMT

Allowing a large number of profitable corporations to pay little or no corporate income tax year after year impairs the legitimacy of the tax system. This inequity is one of the main reasons for the public's dissatisfaction with the tax system.

The perception of fairness holds special importance in a tax system that is based on self-assessment. Enhancing the legitimacy of the tax system was the key rationale underlying the enactment of the U.S. Alternative Minimum Tax. The U.S. Joint Committee on Taxation described the rationale as follows:

> ...Congress concluded that both the perception and the reality of fairness have been harmed by instances in which corporations paid little or no tax in years when they reported substantial earnings, and may even have paid substantial dividends, to shareholders. Even to the extent that these instances may reflect deferral, rather than permanent avoidance, of corporate tax liability, Congress concluded that they demonstrated a need for change.[1]

Public expressions of the need for increased fairness in the corporate tax system most often focus on the fact that some corporations reporting substantial financial statement income to their shareholders pay little or no corporate income tax.

It is important, however, to examine the reasons why financial statement income can be higher than taxable income. For example, some of the differences between financial statement income and taxable income reflect necessary adjustments designed to eliminate double taxation (e.g., intercorporate dividends) or better approximate economic income (e.g., loss carryovers).

The FTC working group report on a CMT concluded that unadjusted financial statement income is an inappropriate reference point for assessing the need for a CMT:

> ...having agreed that some reasons why profitable corporations pay little or no income tax are more acceptable than others, members rejected [an unadjusted] book income approach as potentially unfair on the grounds that it might limit the ability of companies to carryforward real economic losses or impose a minimum tax on equity income and intercorporate

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1 United States, Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 100th Congress, 1st Sess. (May 4, 1987), Federal Tax Reports, Volume 74, No. 19, p. 433.

dividends in circumstances where corporate [income] tax had already been paid.[2]

The Government concurs with the FTC working group that it would be inappropriate to assess the extent of inequity in the tax system on the basis of unadjusted financial statement income.

Adjustments to Financial Statement Income

The adjustments that need to be made to financial statement income to arrive at a suitable reference point for assessing the need for a CMT are discussed below.

Adjustment for Consolidated Reporting

For financial statement purposes, companies often report their income as one group (i.e., on a consolidated basis) to reflect the fact that they essentially function as one economic entity. For tax purposes, however, companies are required to report their income on an individual company basis. Therefore, to avoid double counting, financial statement income should be adjusted to include only that income that would be reported by the companies on an individual basis.

Intercorporate Dividends

A corporation's financial statement income can include dividends received from another corporation. These dividends are a distribution of profits earned by the payor corporation.

For income tax purposes, corporations can deduct the amount of dividends received from another Canadian corporation as well as certain dividends received from foreign corporations. These deductions are allowed in order to recognize that these profits are taxable in the other corporation. To tax these profits again in the hands of the shareholder corporation could result in double taxation.

Dividend income should therefore be removed from financial statement profits to prevent double counting of the underlying profits that may have been taxed already.

Equity Income

Corporations with investments in other corporations may include some amount of income earned by another corporation in their own book income. If the investor

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2 "Corporate Minimum Tax", *Fair Tax Commission Working Group Report* (Toronto, 1992), p. 48. This has also been acknowledged by others. See, for example, Poddar, S. and David Leslie, "Designing a Provincial Corporate Minimum Tax", Report of Proceedings of Forty-Third Tax Conference, *1991 Conference Report* (Toronto: Canadian Tax Foundation, 1992), 21:4.

corporation uses the equity method of accounting for its investment, it will reflect a share of the earnings or loss of the other corporation in its income. Under the tax system, however, corporations are taxed on a legal entity basis. This means that generally each company is taxed only on income from properties owned by and businesses carried on by that corporation.

To prevent double counting of income, adjustments are required to eliminate the income or loss of other corporations that may be reflected in financial statements that are prepared on an equity basis.

Tax-Deferred Gains on Corporate Reorganizations

In certain types of corporate reorganizations the tax system allows assets to be transferred from one corporation to another without the imposition of income tax at the time of transfer (i.e., rollovers). The imposition of tax is generally deferred until the assets are eventually sold to an arm's length party.

For accounting purposes, gains are generally recognized on a corporate reorganization only when the assets are transferred to an arm's length party. Nevertheless, in some circumstances, gains recognized for accounting purposes may be deferred for income tax purposes under the rollover rules. Generally, these transfers do not result in a sale to an arm's length party for economic gain. Therefore, book gains that are deferred for tax purposes under these rollover provisions should be removed from financial statement income for the purposes of determining the need for a CMT.

Losses from Prior Years

For financial statement purposes, corporations report their profits on an annual basis. The tax system, on the other hand, provides a longer time frame for the recognition of income or losses. For tax purposes, corporations are allowed to offset losses against profits earned in other years, subject to certain restrictions. The tax system allows corporations to carry non-capital losses forward seven years and back three years. Capital losses can be carried back three years and carried forward indefinitely, but are only deductible against capital gains.

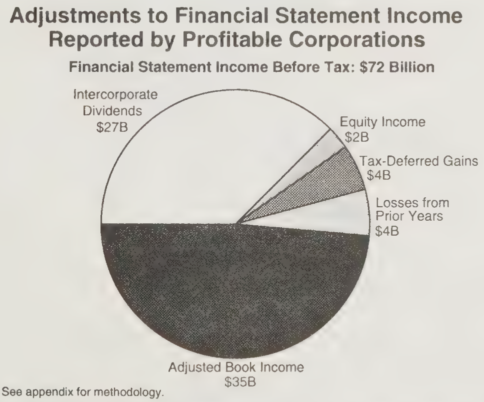
Allowing corporations to carry over losses recognizes the cyclical nature of business activity. The carryover mechanism recognizes that profit levels for any one year may not be an accurate reflection of a corporation's ability to pay over a business cycle. Therefore, financial statement income should be adjusted to reflect losses incurred in prior years.

Analysis of Corporate Profits

In response to the recommendations of the FTC working group, the Government has conducted further analysis to determine the extent to which corporate profits are undertaxed. This analysis was based on a statistical sample of corporate tax returns for the 1989 taxation year. This data was modified to reflect the impact of significant corporate tax changes and more modest levels of corporate profitability.

This analysis indicates that approximately 134,500 corporations operating in Ontario reported total profits of about $72 billion in their financial statements. As Figure 1 indicates, after removing dividends, equity income, tax-deferred gains, and losses from prior years, $35 billion of profits remain. This will be referred to as Adjusted Book Income (ABI) and will form the basis for determining the need for a CMT.

Figure 1



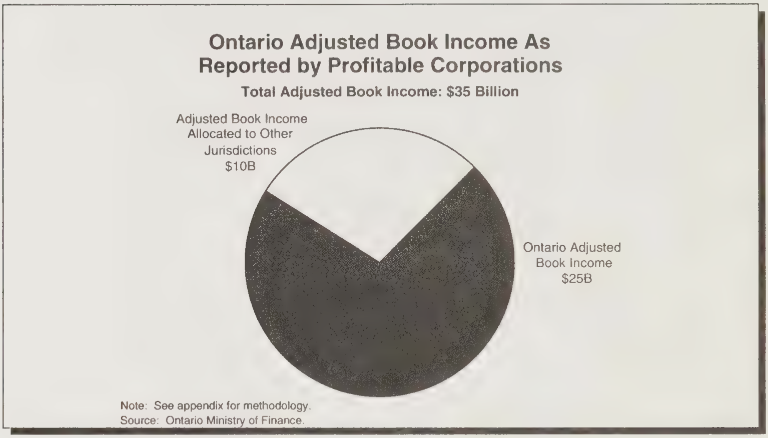
Note: See appendix for methodology.
Source: Ontario Ministry of Finance.

The $35 billion of ABI shown in Figure 1 represents the worldwide profits of all companies operating in Ontario. However, some of these profits may not be subject to tax in Ontario, since they may have been earned in other countries or provinces.

Where a corporation operates in a number of jurisdictions, its taxable income is allocated among those jurisdictions according to a formula that is generally based on the gross revenues and salaries and wages attributable to each jurisdiction. This allocation formula is intended to ensure that each jurisdiction receives tax revenue for profits earned in that jurisdiction, and to prevent profits from being taxed by more than one jurisdiction.

Using this allocation formula, Figure 2 shows that of the $35 billion of ABI, $25 billion would be allocated to, and taxable in, Ontario.

Figure 2



Undertaxed Corporate Profits

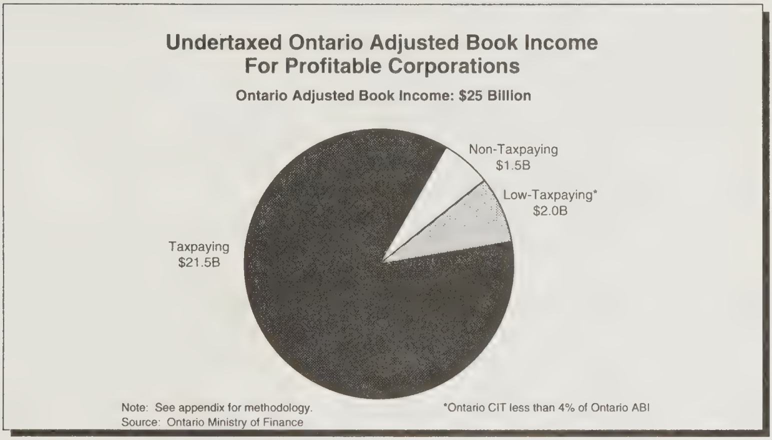
Figure 3 shows that of the $25 billion of ABI allocated to Ontario:

- 8,500 companies reported $1.5 billion of ABI that was subject to no Ontario corporate income tax, and
- a further 4,500 companies reported $2.0 billion of ABI that was subject to Ontario corporate income tax of less than 4 per cent[3] of ABI.

This $3.5 billion of undertaxed corporate profits represents about 15 per cent of total Ontario adjusted book income. Some of the major reasons why this pool of undertaxed corporate profits exists are discussed below.

3 The rate of 4 per cent corresponds to the CMT rate when fully phased-in.

Figure 3



Major Reasons Why Corporate Profits are Undertaxed

The foregoing analysis indicates that, after adjusting financial statement income, there are approximately 13,000 profitable corporations with $3.5 billion in undertaxed profits. This can be attributed to the use of tax preferences.

Tax preferences can take many forms including deductions, credits, exemptions and reduced tax rates. Tax preferences can create permanent or temporary (i.e., timing) differences between financial statement income and taxable income. Permanent differences result in permanent reductions of tax, while timing differences result in temporary deferrals of tax that can be expected to reverse over time.

Permanent differences arise from items such as the tax-free portion of net capital gains, the Ontario Research and Development (R&D) Super Allowance and the Ontario Current Cost Adjustment (OCCA). Timing differences arise from items such as accelerated depreciation rates for tax purposes (i.e., capital cost allowance or CCA), and accelerated write-offs of R&D expenditures and certain resource deductions.

The 1987 federal tax reform measures eliminated many tax preferences and restricted others. Nevertheless, some significant preferences remain.[4] Some of these are described below:

Depreciation: A major tax preference is the excess of CCA over book depreciation. For financial statement purposes, capital assets are amortized or depreciated according to the expected useful life of the asset. For tax purposes, assets are depreciated using a capital cost allowance system. This system generally pools various types of assets into specified classes, and allows corporations to write off the assets of each class at specified rates.

The CCA system often permits faster write-offs than book depreciation and does not necessarily reflect the economic life of an asset. In this way the tax system can be used to encourage corporations to invest in certain assets.

Prior to 1987 federal tax reform, accelerated tax write-offs were used extensively to reduce taxable income. Even though 1987 tax reform reduced accelerated tax write-offs for several classes, considerable differences still exist between CCA and book depreciation.

Capital Gains: The different tax and accounting treatment of gains from the disposition of capital property represents another difference between accounting income and income reported for tax purposes. While capital gains and losses are fully recognized in financial statement income, only three-quarters of net capital gains and allowable capital losses are recognized for tax purposes.

The partial exclusion of capital gains from taxable income recognizes that, unlike income from other sources such as employment or business, which is generally earned on a regular, continuous basis, capital gains often accrue over longer periods of time. The partial non-taxation of capital gains has been justified as compensation for investment risk as well as compensation for the inflationary element inherent in such gains. However, the partial exclusion rate does not vary with the length of time the capital property has been held.

In addition, the tax system provides for capital gains reserves that allow corporations to effectively recognize capital gains for tax purposes as related proceeds are received, within a specified period of time. For book purposes, the full gain would normally be recognized at the time of sale or disposition of the property.

R&D Incentives: Other differences between income reported for financial statement purposes and income reported for tax purposes arise from specific tax provisions designed to encourage particular activities such as research and development. The tax system allows companies to deduct certain current and

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4 A recent study of the impact of federal tax reform prepared by David Holland and Alain Castonguay confirms that tax reform did not eliminate all tax preferences from the tax system. See Holland D. and Alain Castonguay, "The Corporate Income Tax: Preliminary Results on the Impact of Tax Reform", Report of Proceedings of the Forty-Third Tax Conference, *1991 Conference Report* (Toronto: Canadian Tax Foundation, 1992), 20:11.

capital R&D expenditures immediately. For accounting purposes, capital investments and certain expenses are deducted over future periods.

In addition to the immediate write-off for R&D expenditures, Ontario's R&D Super Allowance provides an additional 25 per cent deduction (35 per cent for Canadian-controlled private corporations) for Ontario tax purposes. The R&D Super Allowance is increased by 50 per cent for expenditures in excess of the average level of expenditures for the previous three years.

Resource Expenditures: Resource expenditures are also treated differently for book and tax purposes. For book purposes, a resource corporation may deduct its exploration and development expenses over the expected economic life of each project. For tax purposes, however, these expenditures are grouped into pools and deducted at specified rates. Generally, the deductions allowed for tax purposes result in a faster write-off of these expenditures than those taken for book purposes.

Preferential Tax Rates: Tax preferences can also take the form of tax credits and reduced rates. These do not constitute differences between financial statement income and taxable income, but rather reduce taxes payable directly. For example, certain Canadian-controlled private corporations, manufacturers, processors and resource companies benefit from reduced tax rates. These lower rates have the effect of reducing the amount of corporate income tax paid as a percentage of adjusted book income.

Other Preferences/Adjustments: In addition to the major preferences described above, there are also a large number of other smaller differences between financial statement income and taxable income. While the individual impact of each of these differences is small relative to the preferences described above, in total they can account for a significant amount of undertaxed ABI.

Conclusion

This analysis demonstrates that even after adjusting financial statement income, there remains a significant amount of undertaxed corporate profits. As discussed above, there are many reasons why taxable income may be lower than ABI. A large portion of this undertaxed ABI is due to the use of a few major tax preferences. However, there are also a number of less significant reasons, which, in total, account for a significant amount of undertaxed ABI.

One way to ensure that profitable corporations pay their fair share would be to amend the existing income tax system to restrict or eliminate tax preferences. However, this approach would not only prevent profitable corporations from stacking or combining these preferences to unduly minimize their income tax liabilities, but would also prevent taxpaying corporations from using these preferences – even those paying their fair share.

Furthermore, many tax preferences play an important role in achieving economic renewal objectives by encouraging specific types of business activity. Corporations

undertaking these activities should be able to use these preferences to pay a reduced level of tax on their profits. Profitable corporations, however, should not be able to claim one or more of these preferences to the extent that they are able to avoid completely, or defer indefinitely, their income tax liabilities.

A CMT, on the other hand, would not affect the ability of most regular taxpaying corporations to claim these incentives. Instead, it would specifically target only those profitable corporations that are able to use these preferences to reduce their income tax to unreasonably low levels. In this way, the important economic benefits of the incentives are generally maintained.

A CMT, therefore, would serve an important function by ensuring that profitable corporations pay a reasonable amount of tax on their profits, while maintaining the ability of the Government to deliver important incentives through the tax system.

Design Objectives of a Corporate Minimum Tax

The following objectives were considered in reviewing possible CMT options.

Fairness

The primary objective of a CMT is to improve the fairness of the corporate income tax system by ensuring that profitable corporations pay at least a minimum amount of income tax, based on their ability to pay.

The preceding analysis shows that there are a significant number of profitable corporations that are able to reduce or defer their income tax liabilities through the use of tax preferences. As a result, some less profitable companies currently pay a greater share of income tax than more profitable corporations.

A CMT should reduce this inequity by ensuring that all profitable corporations pay at least a minimum amount of tax, based on their ability to pay.

Some commentators argue that all taxes are ultimately borne by individuals -- by consumers in the form of price increases, or labour in the form of reduced wages, or investors in the form of lower returns on capital. Tax incidence depends on many factors, particularly the structure of labour, capital and consumer markets.

Even if it is accepted that corporate taxes are shifted to individuals, there are several important reasons for levying taxes on corporations.[5] For example, without corporate taxes, income retained in corporations would not be taxed until distribution. This could leave significant amounts of income untaxed for long periods of time. Corporate taxes also serve an important function in taxing non-resident shareholders. Given the existence of corporate taxes, it is important to ensure that such taxes are more evenly distributed.

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5 Ontario Fair Tax Commission, *Discussion Paper: Searching for Fairness* (Toronto, 1993), p. 102.

Neutrality

As noted earlier, the corporate income tax system contains various tax preferences that are designed to encourage certain types of behaviour. While each preference achieves a specific public policy objective, the stacking or combining of these preferences can reduce a corporation's effective tax rate well below that of other corporations. Significant variations in effective tax rates can result in inefficient transactions that cater to tax-saving opportunities rather than economic needs.

A CMT should improve tax neutrality among profitable corporations by ensuring that they cannot utilize tax preferences to the point where they can reduce their corporate income tax below a reasonable level. This would reduce the variation in effective tax rates among profitable corporations.

Simplicity

An important objective of any tax reform measure is to minimize the complexity that results from the change. Minimizing complexity reduces compliance costs for taxpayers and administrative difficulties for government. In addition, complexity tends to reduce the understandability of the tax system and could, thus, impair its legitimacy.

Although complexity can be minimized, it cannot be avoided entirely. To a large extent, the increasing frequency and complexity of tax changes have been the result of a more dynamic and diversified economy that requires the tax system to keep pace with new commercial arrangements. As the level of sophistication in tax planning increases, the need for further technical changes to the tax system will continue.

As the Smith Commission noted in 1967, "It should be understood that after every effort has been made to apply the principle of simplicity ..., certain taxes, notably those on personal and corporate income, will be embodied in statutes that are irreducibly but still appreciably complex."[6]

A CMT should be designed to minimize complexity wherever possible. For example, the CMT could be based on amounts already calculated for financial statement and tax purposes. This would minimize the need for additional calculations.

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6 Ontario, *Report of the Ontario Committee on Taxation*, Volume 1 (Toronto, 1967), p. 20.

Balancing of Objectives

It is important to realize that some objectives may conflict with others. For example, tax fairness may conflict with tax simplicity. Improving the fairness of the tax system may require additional complexity to accommodate the particular circumstances of individual taxpayers.

A CMT should be designed to achieve a balance among these objectives. The primary objective, however, is fairness. The two major tax reform commissions that have reviewed the tax system in the past – the Carter Commission at the federal level and the Smith Commission at the provincial level – both viewed equity as the most important of the competing objectives. The Smith Commission, which undertook a major and comprehensive review of Ontario's tax system in 1967, expressed the following view:

> Whatever the nature of the conflict, we wish to stress that among all the principles that we have discussed, those relating to equity are of fundamental importance in the formulation of tax policy. This is by no means to deny that in specific circumstances equity may legitimately be subordinated to other principles, but where such is argued, we place the burden of proof squarely on the proponents of the case.[7]

Possible Bases for a CMT

As the FTC working group report noted, a minimum tax can take a number of different forms and each form can have a range of different design features. The FTC working group identified a broad range of design options for a CMT. The primary bases considered were capital, adjusted taxable income and adjusted book income.[8]

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7 Ontario, *Report of The Ontario Committee on Taxation*, Volume 1 (Toronto, 1967), p. 21.

8 The FTC working group also considered an Advance Corporations Tax (ACT). In some cases, the intercorporate dividend deduction can overcompensate firms where the corporation distributing the dividend pays little or no income tax. To address this situation, some countries impose an ACT. An ACT is a tax imposed on dividends upon distribution, which can then be credited against income tax paid. This ensures that the dividends bear at least a minimum amount of tax. However, it would be very difficult, if not impossible, for Ontario to impose a provincial tax on corporate distributions since this would require a fully integrated corporate and personal income tax system at the provincial level: See "Corporate Minimum Tax", *Fair Tax Commission Working Group Report*, (Toronto, 1992), p. 45-46; Poddar, S. and David Leslie, "Designing a Provincial Corporate Minimum Tax", Report of Proceedings of the Forty-Third Tax Conference, *1991 Conference Report* (Toronto: Canadian Tax Foundation, 1992), 21:12-13.

Capital Base

A CMT could be based on Ontario's existing capital tax. Ontario's capital tax is based on a company's paid-up capital, which includes its capital stock, retained earnings and most debt. An allowance for investments made in other corporations is deductible to avoid double taxation of capital.

The FTC working group examined the capital tax as a possible base for a CMT. The main advantage of this approach is that it uses an established base that is already familiar to taxpayers. This should reduce complexity since it avoids the introduction of a new base. The working group, however, concluded that, "most members rejected the existing capital tax as a plausible form of corporate minimum tax unless it were to be significantly reformed to exclude loss companies and profitable companies already paying an adequate amount of corporate income tax."[9]

In examining design options for an Ontario CMT, significant efforts were made to increase the profit-sensitivity of a capital tax by the addition of various design features, including credits for losses and corporate income tax paid. The Government also examined base reform. Despite these efforts, the profit-sensitivity of the capital tax could only be increased marginally, and at the expense of significant complexity. As one recent study observes:

> ...there is no simple way to make a capital tax profit-sensitive. Any attempt to link the capital of a corporation to its profits gives rise to many of the same issues that arise under other minimum tax design options. How does one measure profits? What are the compliance costs of requiring corporations to make two sets of income computations, one for the regular income tax and the other for the minimum tax?
>
> If it were impossible to make a capital tax profit-sensitive except through a detailed computation of income, there would be no point in using capital as the base for a minimum tax.[10]

The primary objective of a CMT is to ensure that corporations pay income tax based on their profitability. While a capital tax plays an important role in Ontario's tax mix, a capital tax is not the best way of meeting the objectives of a CMT.

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9 "Corporate Minimum Tax", *Fair Tax Commission Working Group Report* (Toronto, 1992), p. 53.

10 Poddar, S. and David Leslie, "Designing a Provincial Corporate Minimum Tax", Report of Proceedings of Forty-Third Tax Conference, *1991 Conference Report* (Toronto: Canadian Tax Foundation, 1992), 21:19.

Adjusted Taxable Income Base

Under this approach, specified preferences would be added back to taxable income to form the adjusted taxable income base. The base would be subject to CMT at a specified rate and corporations would pay the higher of regular income tax and the CMT.

Minimum taxes based on taxable income concepts exist in both Canada and the United States. In Canada, the joint federal/Ontario personal income tax system imposes an Alternative Minimum Tax (AMT) on individuals. The Canadian personal AMT requires a second calculation of tax. Under this calculation, specified deductions and exemptions available in the regular tax system are added back to taxable income. This second calculation is then compared to regular taxable income. Individuals pay the higher of their regular tax and their AMT.

The United States imposes a more elaborate and complex AMT that applies to both individuals and corporations. The U.S. AMT requires taxpayers to re-calculate taxable income by allowing for various preferences and adjustments. It creates a separate and parallel tax system, which includes a separate depreciation system for AMT purposes as well as a separate system for calculating net operating losses, foreign tax credits and investment tax credits.

The U.S. minimum tax system has been revised many times since its introduction in 1969. One of the most fundamental changes occurred in 1986 when the corporate AMT was amended to include an adjustment based on a broader measure of income.[11] These reforms were designed to "address perceived deficiencies of the minimum tax under the previous law, which did not prevent many apparently profitable corporations from using tax preferences to eliminate their corporate tax liability."[12]

The Government considered various options based on an adjusted taxable income approach and concluded that this approach would not be the best way of meeting the objectives of a CMT for the following reasons:

- It would be impractical to include all tax preferences in the CMT base. Although a few major preferences could be identified for inclusion in the base, there are a large number of other preferences that could not be readily specified without the addition of significant complexity. However, excluding these other preferences could significantly erode the base.
- The CMT burden would fall disproportionately on those companies and sectors that claim targeted preferences. Other corporations or sectors could

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11 From 1987 to 1989, the adjustment was based on accounting income; for years after 1989, the adjustment was based on adjusted current earnings.

12 Dworin, L., "The Corporate Minimum Tax: The U.S. Experience", Report of Proceedings of the Forty-Third Tax Conference, *1991 Conference Report* (Toronto: Canadian Tax Foundation, 1992), 19:1.

escape the CMT despite having larger untaxed ABI. This option, therefore, could create horizontal inequities.

Adjusted Book Income (ABI) Base

Under this approach, the CMT would be based on a corporation's financial statement income with certain adjustments designed to improve the fairness of the base. Financial statement income would be determined in accordance with generally accepted accounting principles (GAAP).

GAAP refers not only to specific rules and practices relating to particular circumstances, but also to a set of broad principles and conventions that are generally accepted within the accounting profession. One of the key objectives of GAAP is the appropriate matching of revenues and expenses. Many of these principles and conventions are codified as accounting recommendations in the Canadian Institute of Chartered Accountants (CICA) Handbook.[13] Under existing corporate law, all large corporations are required to prepare financial statements in accordance with GAAP for presentation to shareholders.[14]

An adjusted book income approach would best meet the key fairness objective of a CMT because it would directly address the problem of a large number of profitable corporations that pay little or no corporate income tax. This approach provides the greatest sensitivity to a corporation's ability to pay. Unlike the capital tax approach, or, to a lesser extent, the taxable income approach, an ABI approach would ensure that corporations suffering economic losses would not be adversely affected. As the FTC working group report notes, "This type of system [adjusted book income] would ensure that most profitable corporations reporting book profits would pay some income tax but would not increase the tax burden on start-up or loss companies or profitable companies already paying significant tax."[15]

In addition, since it does not target specific tax preferences, an adjusted book income approach would not discourage corporations from undertaking those activities. Instead, the CMT would apply whenever a corporation is able to avoid or defer paying a reasonable level of income tax on its reported profits, regardless of which preferences were claimed.

An adjusted book income approach is not without some shortcomings, many of which were discussed by the FTC working group. For example, GAAP allows taxpayers to choose accounting methods that best reflect the nature of their

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13 For a discussion of GAAP, see Canadian Institute of Chartered Accountants, *CICA Handbook* (Toronto: CICA) (looseleaf), para. 1000.59 - 1000.61, p. 111.

14 *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 as amended, s. 155 and Regulations, s. 44; *Business Corporations Act* (Ontario), R.S.O. 1990, c. B-16, ss. 153(1), 154(1), 155 and Regulation 62, R.R.O. 1990, ss. 39, 40.

15 "Corporate Minimum Tax", *Fair Tax Commission Working Group Report* (Toronto, 1992), p. 58.

business activity. Acceptable reporting standards for GAAP purposes can therefore vary among firms and industries in limited circumstances. The FTC working group expressed some concern that this flexibility regarding the selection of GAAP could result in some avoidance and potential complexity in the future.[16]

The FTC working group also noted that not all corporations prepare audited financial statements.[17] Limiting the application of the CMT to larger companies, however, would address this concern. Under both the Ontario *Business Corporations Act* (OBCA) and the *Canada Business Corporations Act* (CBCA), all public companies are required to prepare audited financial statements. The OBCA currently requires private corporations with assets greater than $2.5 million or revenues greater than $5 million to prepare audited financial statements. Under the CBCA, the asset threshold is currently $5 million and the revenue threshold is $10 million.

In many respects, the existing tax system already relies on GAAP. It has been recognized that generally accepted accounting principles have become the standard starting point for the determination of income for tax purposes:

> GAAP have clearly emerged as the benchmark or standard against which the appropriateness of a taxpayer's starting position for determination of profit under subsection 9(1) will normally be judged. It now appears to be unlikely in most circumstances that a court would accept a computation of profit under subsection 9(1), subject to overriding specific provisions of the Act, which was not in accordance with GAAP.[18]

Courts have increasingly come to rely on GAAP not only as the starting point for the determination of income from business and property, but also in the interpretation of other provisions of tax legislation.[19]

It has also been noted that the significance of GAAP is likely to increase over time:

> Indeed, it appears that GAAP will be determinative of the tax consequences of transactions more frequently and consistently than they have been in the past.[20]

Increased reliance on GAAP has come not only from interpretation of tax statutes by courts, but also through legislative changes to the *Income Tax Act* (Canada) that

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16 Ibid., p. 59.

17 "Corporate Minimum Tax", *Fair Tax Commission Working Group Report* (Toronto, 1992), p. 58.

18 Philp, B.M., "Is It Time To Place More Reliance On GAAP?", Report of Proceedings of Forty-Third Tax Conference, *1991 Conference Report* (Toronto: Canadian Tax Foundation, 1992), p. 25:15-16.

19 Ibid. 33-34.

20 Ibid. 36.

essentially require GAAP-like computations.[21] In addition, the federal Large Corporations Tax requires the use of balance sheet accounts "prepared in accordance with generally accepted accounting principles."[22]

In view of the above, ABI would provide a suitable base for a CMT. Since large corporations are already required to prepare their financial statements in accordance with GAAP, ABI would be a reasonably reliable and readily available measure. Most importantly, however, of the three approaches discussed above, ABI is the best measure of a corporation's ability to pay. After detailed analysis, the Government has concluded that the ABI approach would best achieve the objectives of a CMT for Ontario.

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21 *Income Tax Act* (Canada), R.S.C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63 and as subsequently amended. Examples referred to by B.M. Philp, *supra.*, include amendments to: the interest accrual rules in section 12, the grant, reimbursement, inducement rules of para 12(1)(x), the capitalization rules in subsections 18(2) and 18(3.1), the prepaid expense rules in subsection 18(9), the doubtful debt and unearned income rules in subsection 20(1). Also see proposed sections 20.1 and 20.2.

22 *Income Tax Act* (Canada), R.S.C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63 and as subsequently amended, subparagraph 181(3)(b)(i).

Ontario's Corporate Minimum Tax

Ontario's Corporate Minimum Tax (CMT) will be based on a corporation's adjusted financial statement income computed in accordance with GAAP. The CMT will apply to all corporations that are liable for Ontario corporate income tax, subject to the CMT small business exemption.

Figure 4 provides a schematic overview of Ontario's CMT.

Figure 4

Ontario's CMT

Net Income/Loss Per Financial Statements
(before tax, including extraordinary items)

± Adjustment to reflect cost method of accounting
− Dividends
− Tax-deferred gains on rollovers

= **Adjusted Book Income/Loss**

− Pre-CMT adjusted loss carryovers
− Post-CMT adjusted loss carryovers

= **CMT Base**

X Ontario Allocation
X Rate

= **Gross CMT Payable**

− Credit for regular Corporate Income Tax (CIT)
− Foreign tax credits

= **Net CMT Payable ***

* Net CMT payable will be creditable against regular CIT paid in the subsequent ten years.

Description of CMT Base

Ontario's CMT will be based on income for financial statement purposes, computed in accordance with GAAP. Income will be measured before any federal, provincial or foreign income taxes, and will include any extraordinary items. Corporations subject to the CMT will be required to submit audited financial statements.

Where financial statements are not prepared in accordance with GAAP, companies will be required to calculate their income for CMT purposes in accordance with GAAP.[23] Corporations will be permitted to choose accounting policies that best reflect their economic situations, provided that those policies are permitted by GAAP. CMT provisions will be formulated to address changes in accounting policies and retroactive changes to income that are permitted or required by GAAP.

Corporations that are members of a partnership will be required to include their proportionate share of any income or loss of the partnership in their CMT base.

Intercorporate Dividends and Equity Income

Under GAAP, the book income of a corporation with an investment in another corporation may include some amount of income earned by that other corporation. If the investor corporation uses the equity or consolidation methods of accounting for its investment, it will reflect a share of the earnings or loss of the other corporation in its income. If the corporation uses the cost method of accounting, it will include the amount of any dividends received in its income. These dividends represent a distribution of profits earned in the other corporation.

To prevent double taxation of income earned by other corporations, the equity and consolidation methods of accounting will not be allowed for purposes of computing the CMT. Profits will be subject to tax in the corporation that earned them.

In addition, all dividends included in financial statement income (using the cost method of accounting) will be excluded from the CMT base, to the extent that they are deducted for regular income tax purposes under sections 112 or 113 of the *Income Tax Act* (Canada) as adopted by section 34 of the *Corporations Tax Act* (Ontario).

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23 This provision will be similar to that already contained in subsection 181(3) of the *Income Tax Act* (Canada), which deals with the federal Large Corporations Tax.

Tax-Deferred Gains on Corporate Reorganizations

In certain types of corporate reorganizations, the tax system allows assets to be transferred from one corporation to another without immediate income tax consequences. Generally, these transfers do not result in an arm's length sale for economic gain.

Tax-deferred rollovers allow corporations to reorganize their affairs for business purposes without the penalty of prematurely triggering a tax liability. These rules allow corporations the flexibility to reorganize or rationalize their corporate structure so that they can become more efficient and adapt to changing economic conditions.

For financial statement purposes, these gains are generally recognized on a corporate reorganization only when the assets are sold to an arm's length party. Most gains that are deferred for tax purposes are not recognized for financial statement purposes.

In order to ensure that the CMT does not restrict the ability of corporations to reorganize their affairs for business purposes, the CMT base will exclude any book gains that are deferred for tax purposes under certain rollover sections of the *Income Tax Act* (Canada). This will include, for example, reorganizations as contemplated in Division B, subdivision h of Part I of the *Income Tax Act* (Canada) (as adopted by section 29 of the *Corporations Tax Act*).

Carryover of CMT Losses

The CMT recognizes that business cycles may run longer than a year. For example, a corporation may report losses in two successive years, followed by a year of profits. It would not be fair to tax the profits of the third year without recognizing losses of the prior years. Therefore, to recognize that economic income should be measured over a business cycle rather than over a one-year period, recognition should be given for losses incurred in other years.

In recognition of the cyclical nature of business activity, the CMT will allow corporations to carry over losses that are incurred after the CMT (i.e., post-CMT losses) to reduce CMT income. These losses must be computed on a CMT basis. The regular tax system allows non-capital losses to be carried forward seven years and back three years. Allowing corporations to carry back losses under a CMT, however, could significantly increase the complexity of the tax system. It is proposed, therefore, that the CMT provide an extended carryforward period in lieu of a carryback period. Corporations will be allowed to carry forward losses to reduce CMT income of the following ten years. Corporations will be required to apply post-CMT losses in the order that such losses arise and to the extent necessary to reduce the CMT income of subsequent years to nil.

The availability of post-CMT losses will be restricted in acquisition of control situations in the same way that losses are limited under the regular tax system.

Credit for Income Tax Paid

A corporation will be required to pay CMT only to the extent that the CMT liability exceeds its regular income tax liability. This will be accomplished by allowing corporations to reduce CMT otherwise payable by the amount of regular income tax payable for the year (computed net of all credits). As a result, corporations that are already paying a reasonable amount of income tax will not have to pay any additional CMT. This will ensure that CMT is payable only by profitable corporations that are paying no income tax or an unreasonably low amount of income tax.

Foreign Tax Credits

Financial statement profits can include profits that are earned in another country. Double taxation of these amounts can result if these profits are taxed both in Canada and the other country.

Under the federal income tax system, double taxation is prevented by allowing corporations to claim a tax credit in respect of certain taxes paid to foreign countries. Ontario prevents double taxation by using a provincial allocation formula to allocate taxable income among the various provinces and foreign countries. This results in a corporation being subject to Ontario tax only on that portion of its income that is considered to be earned in Ontario.

In certain circumstances, Ontario also allows corporations to claim a tax credit in respect of foreign taxes paid on investment income. In general, this tax credit is equal to the lesser of the Ontario tax on the foreign investment income and the difference between the foreign taxes paid and the federal tax credit allowed in respect of this income. Unused Ontario foreign tax credits cannot be carried forward to reduce income tax of future years.

The CMT will use the allocation formula and, in certain circumstances, allow a foreign tax credit to prevent double taxation.

Credit for CMT Paid

Corporations will be allowed to apply the amount of net CMT paid in a year against their regular corporate income tax liabilities in future years, to the extent that regular income tax (net of all credits) exceeds gross CMT less the foreign tax credits in those years. This will prevent the double taxation of timing differences. For example, a CMT liability could arise in a given year strictly because of timing differences between book income and taxable income. These timing differences could reverse in subsequent years, creating an income tax liability in respect of the same timing differences. In such situations, this credit will ensure that the CMT will function as a prepayment of regular income tax and will not result in an additional tax liability.

The applicable carryforward period will be ten years to compensate for the absence of a carryback system. In effect, this will prevent corporations from deferring their income tax liabilities for longer than ten years. As long as a corporation pays sufficient regular income tax over a ten-year period, the CMT will function only as a prepayment of regular income tax. However, if the corporation is able to defer its income tax liability for more than ten years, the CMT credits will expire, resulting in an additional tax liability.

In order to remove the impact of changes in the Ontario allocation percentage between the year the CMT credit arises and the year it is applied, these credits will be grossed up by dividing the net CMT paid in the year by the Ontario allocation percentage for that year. These grossed-up credits will then be multiplied by the Ontario allocation percentage for the year that they are applied against regular income tax.

Transitional Relief

Retroactivity

The Government recognizes the need to provide transitional relief to minimize any impact that the CMT may have on pre-CMT investment decisions.

The FTC working group recommended that the CMT contain appropriate transitional measures so that companies would not face retroactive taxation for investment decisions made prior to the introduction of the CMT.[24]

Tax incentives arising from pre-CMT investment decisions can be carried forward under the regular tax system in the form of non-capital losses. Therefore, one way of minimizing retroactive taxation of these incentives would be to allow corporations to deduct the tax losses existing upon implementation of the CMT.

However, this would give rise to two problems. First, it could create inequities among corporations. Corporations that have maximized the amount of their pre-CMT losses by claiming the maximum available deductions would receive greater relief than those that have smaller losses, but larger pools of unclaimed expenses (e.g., undepreciated capital cost balances). To eliminate this inequity, further complex adjustments would be required to give some relief for these pools of unclaimed expenses relating to pre-CMT expenditures.

The second problem would arise because these tax losses and unclaimed expense pools consist largely of timing differences, which would ultimately reverse subsequent to the implementation of the CMT. The reversal of these timing differences could result in overtaxation or undertaxation of individual corporations for CMT purposes, depending on whether pre-CMT tax deductions exceed book deductions or vice versa. Very complex adjustments would be required to eliminate this problem.

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24 "Corporate Minimum Tax", *Fair Tax Commission Working Group* (Toronto, 1992), p. 61.

It would be impractical to allow the deduction of pre-CMT tax losses and unclaimed expense pools due to the complexity involved. Instead, the impact of the CMT on pre-CMT investment decisions will be minimized by phasing in the CMT rate over a period of time. This will help offset the potential impact of the CMT on tax incentives arising from pre-CMT investment decisions. Furthermore, since the CMT will be creditable against the excess of regular income tax over the CMT in the subsequent ten years, any CMT attributable to pre-CMT incentives will be recoverable in the future.

Relief for Pre-CMT Losses

The Government also recognizes the need to provide transitional relief for corporations with substantial losses in years prior to the introduction of the CMT. This is consistent with the need to measure CMT profits over a cycle longer than a single year. This transitional relief will be available to corporations on the following basis:

- Corporations will aggregate their income and losses on an adjusted book income (i.e., CMT) basis for the three taxation years preceding the first taxation year that commences after December 31, 1993.
- If the aggregate calculated for this three-year period is a net loss, this pre-CMT loss will be carried forward for up to ten taxation years to be applied against CMT income.
- This pre-CMT loss will be applied to the extent necessary to reduce the CMT base to nil. In the absence of such a rule, a corporation would only apply such a loss to the extent necessary to reduce its CMT liability to the amount of its regular income tax.
- The acquisition of control rules that apply under the regular tax system to a non-capital loss will also apply to a pre-CMT loss.

It is worth noting that these transitional relief measures, together with the profit-sensitive nature of an adjusted book income approach, will minimize any effect of the CMT on Ontario's economic recovery. The ability to carry over losses will ensure that only profitable corporations will be required to pay CMT. Firms that are incurring, or have recently incurred, adjusted book losses will not be subject to the corporate minimum tax.

Reorganizations

Where a corporate group undergoes a reorganization involving an amalgamation or a wind-up, CMT credits and CMT loss carryovers of the predecessor corporations will be carried forward to the surviving entity. These will be subject to restrictions where there has been an acquisition of control. These restrictions will be similar to those that exist for regular income tax purposes.

Maintaining Support for Small Business

The Government recognizes the important contribution of small business to job creation and economic growth. Most small businesses do not have significant resources to devote to tax compliance. The CMT will therefore exempt small businesses.

The Government examined two approaches for structuring the small business exemption. A base deduction approach would allow corporations a deduction from the CMT base (after the deduction of any CMT loss carryovers). The CMT rate would then be applied to the CMT base in excess of the base deduction. This approach is used under the U.S. AMT. Alternatively, under a gross revenue/total asset approach, corporations that meet both the gross revenue/total asset threshold would be exempt from the CMT.

Base Deduction

The key advantage of the base deduction approach is that corporations that exceed the exemption limit by only a small amount would not be required to pay CMT on the full amount of their CMT base. In this way, the base deduction approach would avoid "notch" or equity problems between those firms that fall under the threshold and pay no CMT and those that fall just over the threshold and have to pay CMT on the full amount of their bases.

The major disadvantage of this approach, however, is that most small corporations would have to calculate the amount of their CMT base to determine whether they are exempt. As a result, compliance costs would not be reduced for small businesses. In addition, a corporation's eligibility for exemption could change upon reassessment, since the exemption limit is based on income.

Gross Revenue/Total Assets

Unlike the base deduction test, this approach would not require a calculation of the CMT base to determine eligibility for exemption. Gross revenue and total asset amounts are readily available from financial statements. This approach is similar in principle to that of the small business exemption under Ontario's capital tax.

Furthermore, under this approach the exemption limit would be less likely to change upon reassessment than under the base deduction approach.

Adopted Approach

Since the primary purpose of the exemption is to reduce compliance costs for smaller businesses, it is important that corporations be able to determine whether they are subject to the CMT without having to perform complex calculations. Furthermore, to minimize complexity, the threshold generally should not be

subject to change after the return is filed (e.g., upon reassessment). A gross revenue/total asset test would reduce both uncertainty and complexity.

For these reasons, the CMT includes a threshold based on a combination of the gross revenues and total assets as reflected on the balance sheet of the corporation. The CMT will apply to corporations that have either gross revenues in excess of $10 million, or total assets in excess of $5 million. These amounts provide a reasonable indication of size, and are readily available. The combination of two measures also minimizes potential sectoral biases that could result from a single factor test.

To determine their eligibility for the small business exemption, corporations will be required to aggregate gross revenues and total assets for all corporations in an associated group. If total gross revenues or total assets exceed the threshold amounts, each corporation in the associated group will be required to compute the CMT. This will ensure that larger corporations do not avoid the CMT, for example, by incorporating additional subsidiaries.

It is important to note that this gross revenue/total asset threshold will only be used to determine which corporations are subject to the CMT. It will not be used to determine actual liability for CMT. Only large profitable corporations that have not paid sufficient levels of income tax will be required to pay CMT.

Specialized Corporations

The Government will consult on the application of the CMT to specialized corporations to determine whether specific industry-related provisions are required.

CMT Rate and Implementation Schedule

The CMT will be effective for taxation years commencing after December 31, 1993. A rate of 4 per cent will be levied on the portion of a corporation's CMT base that is allocated to Ontario. The CMT will apply to all corporations that are liable for Ontario corporate income tax, subject to the CMT small business exemption. To provide transitional relief, the CMT rate will be phased in as follows:

- 2 per cent effective January 1, 1994.
- 3 per cent effective January 1, 1995.
- 4 per cent effective January 1, 1996.

The CMT rate will be prorated for taxation years that straddle January 1, 1995 or January 1, 1996. For the first taxation year in which the CMT is effective, the CMT will not affect a corporation's instalment payments and net CMT payable will be due on the date the corporation is required to pay the balance of the other taxes payable under the *Corporations Tax Act* (Ontario). The CMT will form part of the instalment base for subsequent years.

At the fully phased-in rate, the CMT will be approximately 25 per cent of the regular statutory rate of 15.5 per cent. By way of comparison, the United States levies a corporate minimum tax at a rate of 20 per cent, while the top regular tax rate is 34 per cent.[25] Consequently, the U.S. rate of corporate minimum tax is approximately 60 per cent of the top regular tax rate.

Effects of the Corporate Minimum Tax

Revenue Yield of the CMT

When fully phased in at 4 per cent, the CMT is expected to raise about $100 million annually. This revenue yield will not be reached immediately because of three factors. First, as a result of the recession, profit levels may continue to be low. Since the CMT will be profit-sensitive, low profit levels will tend to reduce the amount of CMT that will be raised. Secondly, transitional relief will allow corporations to use their pre-CMT adjusted book losses to reduce their future CMT liability. Finally, because the rate will be phased in, CMT revenue in the first years of implementation will be lower than revenue of fully phased-in years. As a result of these factors, the CMT should not have an impact on Ontario's economic recovery. Because the CMT will be effective for taxation years commencing after December 31, 1993, it is not expected to raise any revenue during the 1993-94 fiscal year.

Sectoral Analysis

The CMT has been designed to ensure that large, profitable corporations paying little or no Ontario corporate income tax will pay CMT. The CMT will not affect profitable corporations paying a reasonable amount of Ontario corporate income tax, nor will it apply to unprofitable corporations.

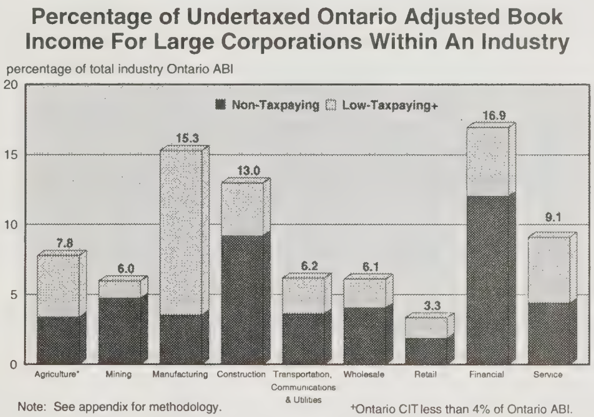
The effect of the CMT on a particular industry will depend on the amount of the undertaxed Ontario ABI earned by large corporations in that industry. The amount of undertaxed Ontario ABI within an industry closely reflects the extent to which an industry currently benefits from tax preferences. This can be determined by measuring the amount of undertaxed Ontario ABI within an industry as a percentage of total Ontario ABI within that industry.

As indicated in Figure 5, all sectors have undertaxed Ontario ABI, but a greater proportion of undertaxed Ontario ABI exists within the manufacturing, construction and financial services sectors. This reveals that these industries tend to benefit more from tax preferences than other industries. It also indicates that firms in these industries will more likely be affected by the CMT. However, since the CMT will be profit-sensitive and creditable against regular corporate income

25 This does not include President Clinton's proposed two percentage point increase to the federal corporate income tax rate for corporations with taxable income over $10 million.

tax, its effect on a particular firm or industry will vary from year to year due to changing levels of profitability and the amount of corporate income tax paid.

Figure 5



Note: See appendix for methodology.
Source: Ontario Ministry of Finance.

+Ontario CIT less than 4% of Ontario ABI.
*Includes farming, fishing and logging.

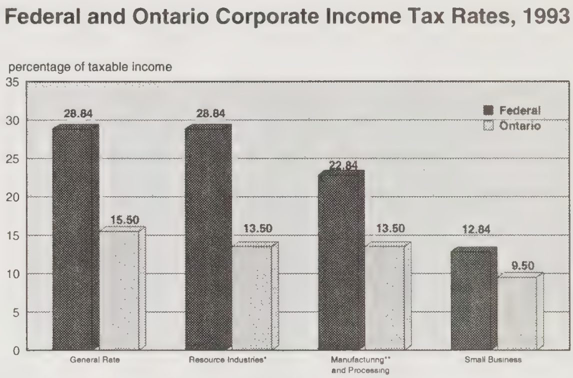
Corporate Tax Rates

There are three ways to express Ontario's corporate income tax rates: the statutory tax rate, the average effective tax rate and the marginal effective tax rate.

Statutory Tax Rates

The statutory corporate income tax rate is the legislated tax rate used to determine the amount of tax payable on taxable income. As depicted in Figure 6, the general statutory tax rate in Ontario is 15.5 per cent. Ontario applies lower tax rates of 9.5 per cent on small business profits of Canadian-controlled private corporations and 13.5 per cent on profits from manufacturing and processing, farming, fishing, forestry and mining. Figure 6 also shows the corporate income tax rates at the federal level.

Figure 6



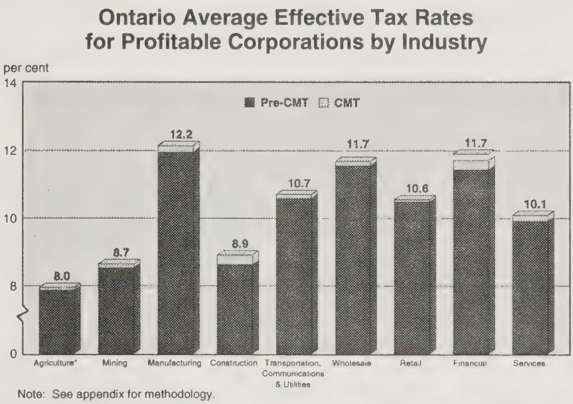
*Includes farming, fishing, logging and mining industries.
**Federal rate will be 21.84% effective January 1, 1994.
Source: Ontario Ministry of Finance.

CMT Effect on Average Effective Tax Rates

One way to determine the effect of the CMT on Ontario's corporate income tax system at any point in time is to measure its impact on the average effective tax rate (AETR) of a particular firm or industry. The AETR is a ratio used to measure the total income tax level of a particular firm or industry relative to its profits. The AETR is calculated by dividing the amount of Ontario corporate income tax paid by the amount of Ontario ABI.[26] Pre- and post-CMT AETRs were calculated for different industries. AETRs vary over time and reflect the point in the profit and investment cycles at which they were calculated.

26 For a more formal definition of AETR, refer to the discussion of methodologies in the appendix.

Figure 7



Note: See appendix for methodology.
Source: Ontario Ministry of Finance.
*Includes farming, fishing and logging.

As shown in Figure 7, the CMT will have a relatively small effect on existing AETRs by industry. This indicates that the amount of CMT paid by a particular industry will not significantly increase the overall income tax level of that industry. Figure 7 also indicates that the CMT will have a greater effect on the AETRs of those industries with larger percentages of undertaxed Ontario ABI.

It is important to note that the effect of the CMT on firms within an industry will vary. The AETRs of large profitable corporations currently paying a reasonable amount of income tax and small businesses will not be affected by the CMT. However, the AETRs of large profitable corporations currently paying little or no income tax could increase by as much as 4 percentage points in a given year.

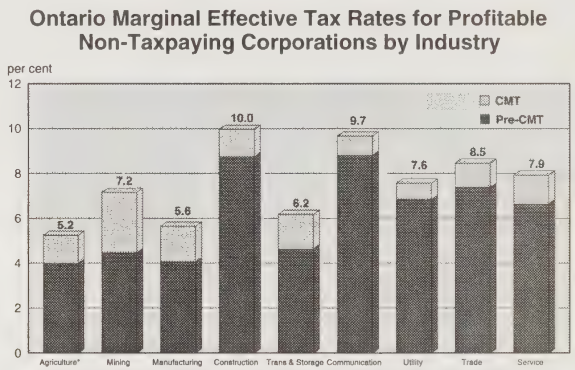
By increasing the AETRs of large profitable corporations currently paying little or no Ontario corporate income tax, the CMT will improve the fairness of the Ontario corporate tax system.

Maintaining Incentives to Invest — Marginal Effective Tax Rate

Due to increased global competition and the need to encourage new investment, it is important that a CMT not eliminate tax incentives to invest in Ontario's economy. The potential effect of the CMT on these investment incentives can be determined by measuring the effect of the CMT on Ontario's marginal effective tax rates (METR). The METR measures the amount of income tax paid on the profits

generated by the last dollar invested.[27] The METR is used to measure the extent to which firms or industries benefit from tax incentives. All other factors remaining equal, the more generous the tax incentives for new investment in a particular firm or industry, the lower the METR for that firm or industry. Pre- and post-CMT METRs were calculated for large, profitable non-taxpaying corporations by industry.[28]

Figure 8



Note: See appendix for methodology.
Source: Ontario Ministry of Finance
*Includes farming, fishing and logging.

As indicated in Figure 8, the METRs of large, profitable non-taxpaying corporations will increase. However, the METRs of regular taxpaying corporations will not be affected. Since the majority of corporations are taxpaying, the overall effect of the CMT on METRs will be minimal. Therefore, even after the introduction of the CMT, the investment incentives offered by the Government through the corporate income tax system will be generally maintained.

Figure 8 also shows that the CMT will tend to have a greater effect on those industries with the lowest METRs. As a result, the CMT will reduce the variation in METRs among industries. The variation in METRs indicates that some industries benefit more from tax preferences than others. Significant variations

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27 For a more formal definition of marginal effective tax rate, refer to the discussion of methodologies in the appendix.

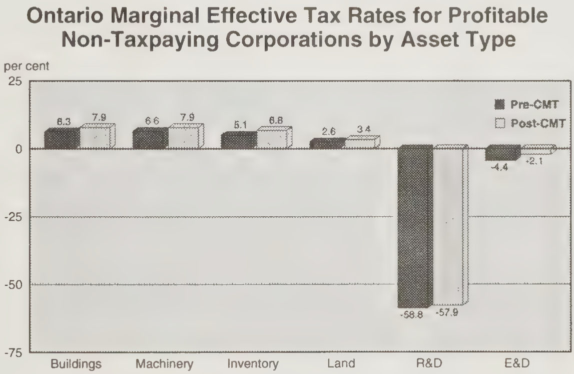
28 "Non-taxpaying corporations" are defined as corporations with economic income currently reporting losses for tax purposes.

can allow tax considerations to unduly distort business decisions affecting the allocation of investment funds. By reducing the difference in METRs, the CMT will help to establish a tax environment that will lead to investment decisions based more on economic considerations and less on tax considerations. Such a tax environment will be more conducive to Ontario's long-term economic growth.

Because of its profit-sensitivity, the CMT will also have little effect on the growth of high-risk ventures or start-up firms that tend to be unprofitable during their early stages of development. As these firms mature and their profit levels increase, the effect of the CMT will be small because the losses incurred in the early stages of development can be used to offset profits in the future. Only after these firms become profitable and exhaust their loss carryforwards will they potentially become subject to the CMT.

Pre- and post-CMT METRs were also calculated for large, profitable non-taxpaying corporations by asset types (i.e., land, buildings, machinery and equipment, research and development, and exploration and development).

Figure 9



Note: See appendix for methodology.
Source: Ontario Ministry of Finance.

As indicated in Figure 9, the CMT will generally maintain tax incentives for new investments, especially research and development (R&D), and exploration and development (E&D). The negative METRs on these two types of assets indicate that the value of the tax incentives will continue to be greater than the amount of tax paid on the profits generated from the last dollar invested in those assets.

Competitiveness

The CMT will affect large, profitable corporations that pay little or no Ontario corporate income tax. Compared to the United States, Canada provides a significant tax advantage for profitable corporations reporting tax losses (i.e., "non-taxpaying corporations"). According to a recent study,[29] the marginal effective tax rates for non-taxpaying corporations in Canada and the United States in 1990 were 3.8 per cent and 13.7 per cent, respectively.

It is important to realize that Canada's largest trading partner, the United States, has a corporate Alternative Minimum Tax (AMT). The U.S. corporate AMT was introduced to ensure that no corporation with "substantial economic income could avoid significant income tax liability by using preferential exclusions, deductions and credits."[30]

Between 1987 and 1990, receipts from the U.S. corporate AMT quadrupled from U.S. $2 billion to U.S. $8 billion and the number of taxpayers with AMT liabilities almost doubled from 17,000 to 32,000. Over the same period, credits against the regular tax for AMT paid in prior years totalled U.S. $2 billion. Most of the AMT was paid by corporations with assets of U.S. $500 million or more. By 1990, the AMT in the United States accounted for approximately eight per cent of corporate tax liabilities.[31]

In some respects, Ontario's CMT will be more equitable than the U.S. AMT since, unlike the U.S. AMT, it will allow full loss carryovers.

Corporate minimum taxes have also been introduced at the state level. Alaska, California, Florida, Iowa, Maine, Minnesota and New York have all introduced their own state AMT for corporations.

Even with the introduction of a CMT, Ontario will continue to have a competitive corporate tax system. Corporations that pay their fair share of regular corporate income tax will continue to benefit fully from Ontario's existing tax incentives. They will also benefit from recent initiatives. For example:

- The corporate income tax rate for manufacturing and resource industries was reduced to 13.5 per cent from 14.5 per cent, effective January 1, 1993.
- The tax depreciation rate (i.e., capital cost allowance) for new manufacturing and processing machinery and equipment was increased to 30 per cent from 25 per cent, effective February 26, 1992.

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29 See McKenzie K. and Jack Mintz, "Tax Effects on the Cost of Capital", *Canada-U.S. Tax Comparisons*, National Bureau of Economic Research, edited by John B. Shoven and John Whalley (1992), p. 211. The study excludes the effects of the U.S. corporate alternative minimum tax on the marginal effective tax rates of U.S. corporations.

30 U.S. Department of Treasury, *Temporal Aspects of the Corporate Alternative Minimum Tax: Results Corporate Panel Data for 1987-1990* (1992), p. 1.

31 Ibid.

- The 1992 Ontario Budget introduced enhancements to R&D tax incentives and the 1993 Ontario Budget includes measures to foster technological innovation.

As a result of both federal and Ontario initiatives, in 1994 the manufacturing corporate income tax rate in Ontario will be four percentage points below the average combined statutory tax rate in the United States.[32] The increased capital cost allowance rate for manufacturing and processing machinery and equipment is comparable to the seven-year write-off rate in the United States.

In addition to Ontario's corporate income tax advantage for manufacturing firms, Ontario has significantly lower payroll taxes and employer-paid health care costs compared to the United States. For example, the Canada Pension Plan rate in 1993 is 2.5 per cent for employers, whereas the social security rate in the U.S. is 7.65 per cent for employers. In Ontario, large manufacturers pay about $700 per employee under the Employer Health Tax. Manufacturers in the United States pay, on average, over $4,200 in health care premiums for comparable health care coverage for their employees.[33] According to the U.S. National Association of Manufacturers, "Escalating health care costs currently are the number-one concern of American manufacturers relative to their ability to compete in world markets."[34]

Overall, Ontario's corporate tax system for manufacturers will continue to be competitive with other jurisdictions, especially when payroll taxes and employer-paid health care costs are considered.[35]

Taxes are only one factor that determine the competitive strength of a jurisdiction. Ontario's other competitive strengths include proximity to large markets, a fast-growing and highly skilled labour force, a well-developed infrastructure and a high quality of life. For example:

- Ontario is centrally located in the North American market. Total household income within one day's trucking distance of Toronto is higher than that of any other major North American city.[36]
- International comparisons of the quality of the labour force rank Canada high relative to other major economies. For example, the World Economic Forum's 1992 report ranked Canada second among major economies in secondary

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32 This does not include President Clinton's proposed two percentage point increase to the federal corporate income tax rate for corporations with taxable income over $10 million.

33 U.S. Chamber of Commerce, *Employee Benefits: Survey Data from Benefit Year 1991* (Washington, 1992), p. 20.

34 National Association of Manufacturers, *Meeting the Health Care Crisis* (1989), p. i.

35 It is important to note that the mix of taxes varies by jurisdiction. Accordingly, the total level of taxation in any one jurisdiction will vary by sector and level of profitability.

36 Ontario Ministry of Treasury and Economics, "Investing in Tomorrow's Jobs", *Ontario Budget Paper 1992* (Toronto, 1992), p. 8.

school and higher educational enrolment, and third for its labour force participation, up from fourth position in 1991.[37] The quality of the province's labour force is a major factor attracting new investment to Ontario.

- Ontario has a well-developed physical and communications infrastructure. The World Economic Forum ranked Canada among the top five industrial nations for power supply,[38] telecommunications,[39] and water costs.[40] In addition, Ontario has a strong financial and business services infrastructure. Half of Canada's top 100 non-financial corporations are based in Ontario, and Toronto is the centre of banking, trust, insurance and securities activities. A 1992 U.S. study ranked Toronto as the fifth most desirable city in the world for locating an international head office.[41]
- Ontario has a high quality of life – an essential ingredient for attracting and retaining a highly skilled labour force. The 1992 report of the United Nations Development Programme ranked Canada as the most desirable country to live in, based on its Human Development Index of per capita incomes, education levels and life expectancy.[42]

Conclusions

The Government is committed to improving the fairness of the tax system. Greater tax fairness improves public trust and confidence in the tax system. A CMT will play an important role in improving tax fairness.

The CMT will be sensitive to ability to pay and will only affect those large corporations that report adjusted book profits and pay little or no corporate income tax. The Government is also committed to economic renewal. The CMT has been designed to exempt small businesses and to minimize any effects on new investments in research and development, high-risk ventures and start-ups. The CMT will not materially affect Ontario's tax competitiveness with the United States.

The Government will be consulting with the public on the technical details of the CMT. The Government plans to conclude these consultations by September 30, 1993.

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37 World Economic Forum, *World Competitiveness Report, 1992* (Geneva, 1992), p. 45.

38 Ibid., p. 491.

39 Ibid., p. 492.

40 Ibid., p. 498.

41 "World's Cities Ranked As Headquarters Locations", PHH Fantus, One Prudential Plaza, Chicago, Ilinois, 60601, U.S. (September 18, 1992).

42 United Nations Development Programme, *Human Development Report 1992* (New York, 1992), p.19.

Appendix: Methodology

Corporate Tax Database

Determining the extent of undertaxed corporate profits and analyzing the effect of the CMT was carried out using a detailed sample of corporations with taxable income allocated to Ontario. This database was created by matching corporate tax data for a representative sample of corporations supplied by Revenue Canada with Ontario corporate tax data on a company by company basis. The data supplied by Revenue Canada, featuring over 1,200 information fields, was transcribed from actual tax returns (including financial statements) filed for 1989, the most recent year available. There were about 6,300 corporations in this matched sample. By assigning a weight to each corporation in the sample, the data provides an accurate representation of corporate taxfilers in Ontario.

Adjustments were made to the database to reflect the effects of significant tax changes since 1989. These adjustments include changes to statutory tax rates and CCA rates and an increased rate of inclusion for capital gains. In addition, the database was adjusted to reflect a more modest level of profitability. This produced a more appropriate database to examine the effects of the CMT. No behaviourial response was taken into account when making these adjustments.

Average Effective Tax Rate Calculation

The pre-CMT average effective tax rates (AETRs) presented in Figure 7, were calculated using the following formula:

$$AETR_i = [CIT_i + PYL_i - CYLCB_i - CYLCF_i]/\text{Ontario ABI before losses}$$

where

CIT_i = Ontario corporate income taxes (net of any credits) paid by a particular industry;

PYL_i = Tax value of prior years' losses claimed in the current year by a particular industry;

$CYLCB_i$ = Tax value of current year losses carried back to reduce taxable income of prior years by a particular industry; and

$CYLCF_i$ = Discounted tax value of current year losses carried forward by a particular industry.

AETRs were calculated for only those corporations with Ontario adjusted book income greater than zero.

Post-CMT AETRs were calculated by adding an expression CMT_i to the numerator of the above formula. This expression measures the discounted value of the CMT paid by a particular industry that is creditable against future corporate income tax.

To isolate the current year effect of income taxation on adjusted book income earned in the year, the following adjustments were made to Ontario corporate income tax paid in the year in the numerator:

- The tax value of prior year losses was added to Ontario corporate income tax paid; and
- The tax value of current year losses carried back and the discounted tax value of current year losses carried forward were subtracted from Ontario corporate income tax paid.

Marginal Effective Tax Rate Calculation

The marginal effective tax rates (METRs) presented in Figures 8 and 9 were derived under the following set of assumptions:

- Corporations are large profitable non-taxpaying firms that are unable to take full advantage of all deductions and credits until some future time when they become taxpaying.
- Debt/asset ratios are fixed and are the same across all the industries.
- Corporations invest so as to maximize the present value of their cash flows.
- The nominal interest rate and return on equity are determined by international markets.

The METR for a given type of capital, T, is the proportional difference between the before-tax rate of return required by an investor, R_g, and the corresponding after-tax rate of return required by a saver, R_n:

$$T = [(R_g - R_n)/R_g] \times 100$$

The after-tax rate of return is a weighted average of the rate of return on debt and the rate of return on equity, determined as follows:[43]

$$R_n = \beta i + (1-\beta)\varrho - \pi$$

where

i = nominal interest rate of bonds;

ϱ = nominal rate of return on equity;

β = debt to asset ratio; and

π = the rate of inflation.

Before-tax rates of return were calculated for non-taxpaying corporations under two scenarios: pre-CMT and post-CMT. The calculations for depreciable assets are set out below. Similar calculations were made for inventory and land.

Pre-CMT

The before-tax rate of return without the CMT for depreciable assets is determined by the following formula:[44]

$$R_g = (r_f+\delta)(1-uB_tZ)/(1-uB_t) + (1+r_f)(uB_tZ-uB_{t-1}Z)/(1-uB_t) - \delta$$

where

u = Ontario's corporate income tax rate;

B_t = Discount factor for calculating the present value of corporate income taxes paid on each dollar of marginal net revenues earned by a non-taxpaying firm;

t = The year when the non-taxpaying firm makes an investment;

r_f = The after-tax cost of financing for the non-taxpaying firm;

δ = The rate of economic depreciation; and

Z = The present value of the CCA deductions.

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43 The formula for the after-tax rate of return is taken from R. Boadway, N. Bruce and J. Mintz, *Taxation, Inflation and the Effective Marginal Tax Rate on Capital*, Canadian Journal of Economics, Vol. 17, 1984, pp. 62-80.

44 The formula for the before-tax rate of return is taken from J. Mintz, *Economic Implications of Non-Refundability of Tax Losses, Policy Options For The Treatment of Tax Losses in Canada*, The Clarkson Gordon Foundation, 1990, pp. 4:1-4:43. Similar before-tax rates of return were calculated for land and inventory.

In this formula, the first two terms measure the user cost of capital for a non-taxpaying firm. The first term is the user cost of capital for tax-paying firms adjusted for the discounted value of corporate income taxes that will be paid by the non-taxpaying firm in the future. The second term is added to measure the cost of investing in a depreciable asset that yields a stream of tax depreciation deductions that are unclaimed until a later period of time.

Post-CMT

The before-tax rate of return after the CMT for depreciable assets is determined by the following formula:

$$R_g = (r_f+\delta)(1-uB_tZ-\lambda_t)/[1-(\tau+(u-\tau)B_t)] + (1+r_f)(uB_tZ-uB_{t-1}Z+\lambda_t-\lambda_{t-1})/[1-(\tau+(u-\tau)B_t)] - \delta$$

where

τ = CMT rate based on the adjusted book income;

$\tau+(u-\tau)B_t$ = The present value of the aggregate of the corporate minimum tax and corporate income tax paid on each dollar of marginal net revenue earned by a non-taxpaying firm from its new investment; and

λ_t = Present value of book depreciation allowed for CMT purposes.

In this formula, the first two terms measure the pre-CMT user cost of capital for non-taxpaying firms adjusted for the CMT currently paid by the firm and credited against corporate income tax paid in the future.

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